

**MILLENNIUM CHALLENGE
CORPORATION**

[MCC FR 05-16]

**Report on the Criteria and
Methodology for Determining the
Eligibility of Candidate Countries for
Millennium Challenge Account
Assistance in FY 2006**

AGENCY: Millennium Challenge Corporation.

SUMMARY: This report to Congress is provided in accordance with Section 608(b) of the Millennium Challenge Act of 2003, 22 U.S.C.A. 7701, 7707(b) (the "Act"). The Act authorizes the provision of Millennium Challenge Account ("MCA") assistance to countries that enter into compacts with the United States to support policies and programs that advance the prospects of such countries achieving lasting economic growth and poverty reduction. The Act requires the Millennium Challenge Corporation ("MCC") to take a number of steps in determining the countries that, based on their demonstrated commitment to just and democratic governance, economic freedom and investing in their people, will be eligible for MCA assistance during Fiscal Year 2006. These steps include the submission of reports to the congressional committees specified in the Act and the publication of Notices in the **Federal Register** that identify:

1. The countries that are "candidate countries" for MCA assistance during Fiscal Year 2006 based on their per-capita income levels and their eligibility to receive assistance under U.S. law and countries that would be candidate countries but for legal prohibitions on assistance (Section 608(a) of the Act);

2. The criteria and methodology that the Board of Directors of MCC (the "Board") will use to measure and evaluate the relative policy performance of the candidate countries consistent with the requirements of Section 607 of the Act in order to select "eligible countries" from among the "candidate countries" (Section 608(b) of the Act); and

3. The list of countries determined by the Board to be "eligible countries" for Fiscal Year 2006, including which of the eligible countries the Board will seek to

enter into MCA compacts (Section 608(d) of the Act).

This report sets out the criteria and methodology to be applied in determining eligibility for FY06 MCA assistance.

Changes to the Criteria and Methodology for FY 2006

MCC has received constructive input on the indicators since the announcement of FY05's selection criteria and methodology. That input has been taken into account in creating the criteria and methodology for the selection of eligible countries for FY06.

MCC has decided to make one change in the policy indicators for the FY06 selection process. In the FY05 Report, we signaled our intention to consider additional measures of government policies to encourage entrepreneurship and private sector ownership. For FY06, MCC will substitute an additional indicator from the World Bank Group's Doing Business report, Cost of Starting a Business, for a current indicator in this category, Country Credit Rating.

MCC believes there are potentially significant gains from adopting this additional measure of the entrepreneurial environment. The proposed indicator meets all of our criteria for an indicator, including a strong empirical relationship to growth. Moreover, we believe there are potentially significant gains in terms of country reforms from adopting another indicator from the Doing Business report because the indicators in it tend to be highly actionable. For example, we are currently using the Days to Start a Business indicator and have seen significant improvements in the median score for low income countries: from 62 days in 2002 to 45 days in 2005. According to the World Bank Group, 80% of the business start-up reforms that they have observed are directly attributable to the incentive effect of the MCA.

The strength of this new indicator is that countries can easily identify areas that require improvement and make quick administrative changes that produce immediate improvements. Governments can lower the cost of business start-up by creating single access points, making registration electronic, introducing temporary business licenses, eliminating statutory time limits and mandatory use of notaries and judges, standardizing paperwork, and eliminating non-essential fees, transfer taxes, stamp duties, as well as payments to property registries, notaries, public agencies and lawyers. In some cases a country can dramatically improve its score by

simply reducing or eliminating notary fees that frequently are commensurate with the average citizen's annual income.

We are substituting Cost of Starting a Business for Country Credit Rating, a current indicator which we see as problematic. First, all of our indicators should be policy-linked and measure policies that a government can change. The existing literature on the determinants of country credit rating suggests that this metric is influenced not only by domestic policies (e.g., inflation, reserve holdings, current account deficits, export growth, debt-GDP ratios, corruption, rule of law, and default risk) but also by many exogenous factors (e.g., initial income, international interest rates, growth rates in industrialized nations, commodity price fluctuations, export composition). It is therefore not clear how quickly and to what degree domestic policy changes will affect this variable. In addition, this indicator appears to have more of an income bias than other indicators MCC is using.

Potential Future Changes Under Consideration: In addition to the change identified above, there are several potential future changes to the indicators that we will explore for the FY07 process. We are signaling these potential changes in order to solicit comments from the public and to provide countries an opportunity to evaluate their performance in these areas in advance of any such future changes in the selection process.

We hope that by highlighting our intention to look for better and more comprehensive indicators we will stimulate interest in improving the available data. In assessing new indicators, we will favor those that: (1) Are developed by an independent third party, (2) utilize objective and high-quality data, (3) are analytically rigorous and publicly available, (4) have broad country-coverage and are comparable across countries, (5) have a clear theoretical or empirical link to economic growth and poverty reduction, (6) are policy-linked, *i.e.* measure factors that governments can influence within a two to three year horizon, and (7) have broad consistency in results from year to year.

A summary of the results of research undertaken throughout the past year and the identification of potential future changes to the selection criteria and methodology follows:

Encouraging Economic Freedom: Trade Policy: In the FY05 Report, MCC signaled exploration of a more comprehensive measure of trade barriers. MCC has not identified a more

comprehensive measure with good country coverage and which is publicly available and we will continue to research these issues for a possible change in FY07.

Natural Resources Management: MCC has launched a public process led by MCC Board Member Christine Todd Whitman in search of a natural resource management indicator. MCC has sought broad input from the academic community, public and private sector practitioners, and researchers at think tanks and NGOs. We have consulted with environmental experts from across the country, who have provided extremely valuable guidance to MCC, and have published a public "request for ideas" for an indicator or index. We have enlisted the help of six experts to individually rate proposals and submit independent evaluations to MCC, and will discuss with the Board later this year whether we have succeeded in identifying a potential indicator for FY07. In the interim, MCC will provide the Board with quantitative and qualitative supplemental information in the natural resource management area.

(Note: In FY05, we signaled MCC's intention to consider a reduction in the threshold on the Inflation indicator from 15% to 10% in FY06. However, we have not found credible evidence to support a further reduction, and MCC will continue to apply the 15% threshold.)

Investing in People: Women's and Children's Health: In FY05, MCC signaled an interest in finding additional ways to measure investments in people, particularly with respect to women and children, in accordance with the legislation. In particular, we singled out Skilled Attendants at Birth (SBA) (a proxy for maternal mortality which measures births attended by medically-trained midwives, nurses or doctors) for potential use in FY06. After extensively reviewing the data, the methodology, and the literature on skilled birth attendants, we cannot adopt this indicator for inclusion as an indicator in the FY06 selection process due to poor data quality and lack of adequate country coverage. We remain interested in identifying measures of government policies that support women's and children's health, however, and will look for improvements in country coverage, frequency, definitional consistency, and data quality in the SBA indicator. MCC will continue to explore additional and better ways to measure investments in people, particularly with respect to women and children, for use in the selection criteria in future years.

Criteria and Methodology

The Board will select eligible countries based on their overall performance in relation to their peers in three broad policy categories: Ruling Justly, Encouraging Economic Freedom, and Investing in People. Section 607 of the Act requires that the Board's determination of eligibility be based "to the maximum extent possible, upon objective and quantifiable indicators of a country's demonstrated commitment"

to the criteria set out in the Act. For FY06, there will be two groups of candidate countries—low-income countries and lower-middle income countries. Low-income candidate countries refer to those countries that have a per capita income equal to or less than \$1575 and are not ineligible to receive United States economic assistance under part I of the Foreign Assistance Act of 1961 by reason of the application of any provision of the Foreign Assistance Act or any other

provision of law. Lower-middle income candidate countries are those that have a per capita income between \$1,575–\$3,255 and are not ineligible to receive United States economic assistance.

The Board will make use of sixteen indicators to assess policy performance of individual countries (specific definitions of the indicators and their sources are set out in Annex A). These indicators are grouped for purposes of the assessment methodology under the three policy categories as follows:

Ruling Justly:	Encouraging economic freedom:	Investing in people:
1. Civil Liberties 2. Political Rights 3. Voice and Accountability 4. Government Effectiveness 5. Rule of Law 6. Control of Corruption	1. Cost of Starting a Business 2. 1-year Consumer Price Inflation 3. Fiscal Policy 4. Trade Policy 5. Regulatory Quality 6. Days to Start a Business	1. Public Expenditures on Health as Percent of GDP. 2. Immunization Rates: DPT3 and Measles. 3. Public Primary Education Spending as Percent of GDP. 4. Girls Primary Education Completion Rate.

In making its determination of eligibility with respect to a particular candidate country, the Board will consider whether a country performs above the median in relation to its peers on at least half of the indicators in each of the three policy categories and above the median on the corruption indicator. One exception to this methodology is that the median is not used for the Inflation indicator. Instead, to pass the Inflation indicator a country's inflation rate needs to be under a fixed ceiling of 15%. The indicator methodology will be the predominant basis for determining which countries will be eligible for MCA assistance. In addition, the Board may exercise discretion in evaluating and translating the indicators into a final list of eligible countries. In this respect, the Board may also consider whether any adjustments should be made for data gaps, lags, trends, or other weaknesses in particular indicators. Likewise, the Board may deem a country ineligible if it performs substantially below the median on any indicator and has not taken appropriate measures to address this shortcoming.

Where necessary, the Board may also take into account other quantitative and qualitative information to determine whether a country performed satisfactorily in relation to its peers in a given category. As provided in the Act, the CEO's report to Congress setting out the list of eligible countries and identifying which of those countries the MCC will seek to enter into Compact negotiations with will include a justification for such eligibility determinations and selections for Compact negotiation.

There are elements of the criteria set out in the Act for which there is either

limited quantitative information (e.g., rights of people with disabilities) or no well-developed performance indicator (e.g., sustainable management of natural resources). Until such data and/or indicators are developed, the Board may rely on supplemental data and qualitative information to assess policy performance. For example, the State Department Human Rights report contains qualitative information to make an assessment on a variety of criteria outlined by Congress, such as the rights of people with disabilities, the treatment of women and children, worker rights, and human rights. Similarly, as additional information in the area of corruption, the Board may consider how a country scores on Transparency International's Corruption Perceptions Index as well as on the defined indicator.

The Board's assessment of a country's commitment to economic policies that promote the sustainable management of natural resources may make use of quantitative and qualitative information such as access to sanitation, deforestation, conservation of land and marine resources, land tenure institutions, and protection of threatened and endangered species. MCC has launched a public process to identify a suitable potential indicator.

Relationship to Legislative Criteria

Within each policy category, the Act sets out a number of specific selection criteria. As indicated above, a set of objective and quantifiable policy indicators is being used to establish eligibility for MCA assistance and measure the relative performance by candidate countries against these criteria. The Board's approach to

determining eligibility ensures that performance against each of these criteria is assessed by at least one of the sixteen objective indicators. Most are addressed by multiple indicators. The specific indicators used to measure each of the criteria set out in the Act are as follows:

Section 607(b)(1): Just and democratic governance, including a demonstrated commitment to—

(A) Promote political pluralism, equality, and the rule of law; Indicators—Political Rights, Civil Liberties, Voice and Accountability and Rule of Law

(B) Respect human and civil rights, including the rights of people with disabilities; Indicators—Political Rights and Civil Liberties

(C) Protect private property rights; Indicators—Civil Liberties, Regulatory Quality and Rule of Law

(D) Encourage transparency and accountability of government; and Indicators—Political Rights, Civil Liberties, Voice and Accountability, and Government Effectiveness

(E) Combat corruption.

Indicators—Civil Liberties and Control of Corruption

Where necessary the Board will also draw on supplemental data and qualitative information, including the State Department's Human Rights Report and Transparency International Corruption Perception's Index.

Section 607(b)(2): Economic freedom, including a demonstrated commitment to economic policies that—

(A) Encourage citizens and firms to participate in global trade and international capital markets; Indicators—Fiscal Policy, Inflation, Trade Policy, and Regulatory Quality

(B) Promote private sector growth and the sustainable management of natural resources; Indicators—Inflation, Days to Start a Business, Cost of Starting a Business, Fiscal Policy, and Regulatory Quality

(C) Strengthen market forces in the economy; and Indicators—Fiscal Policy, Inflation, and Regulatory Quality

(D) Respect worker rights, including the right to form labor unions. Indicators—Civil Liberties

Where necessary the Board will also draw on supplemental data and qualitative information including the State Department's Human Rights Report, access to sanitation, deforestation, conservation of land and marine resources, land tenure institutions, and protection of threatened and endangered species.

Section 607(b)(3): Investments in the people of such country, particularly women and children, including programs that—

(A) Promote broad-based primary education; and

Indicators—Girls' Primary Education Completion Rate and Public Spending on Primary Education.

(B) Strengthen and build capacity to provide quality public health and reduce child mortality. Indicators—Immunization and Public Spending on Health.

Annex A: Indicator Definitions

The following 16 indicators will be used to measure candidate countries' adherence to the criteria found in Section 607(b) of the Act. The indicators are intended to assess the degree to which the political and economic conditions in a country serve to promote broad-based sustainable economic growth and thus provide a sound environment for the use of MCA funds. The indicators are not goals in themselves; rather, they measure policies that are necessary conditions for a country to achieve broad-based sustainable economic growth. The indicators were selected based on their relationship to growth and poverty reduction, the number of countries they cover, their transparency and availability, and their relative soundness and objectivity. Where possible, the indicators rely on indices of performance developed by independent sources.

Ruling Justly

(1) *Civil Liberties*: A panel of independent experts rates countries on: freedom of expression, association and organizational rights, rule of law and human rights, and personal autonomy

and economic rights. Source: Freedom House.

(2) *Political Rights*: A panel of independent experts rates countries on: the prevalence of free and fair elections of officials with real power; the ability of citizens to form political parties that may compete fairly in elections; freedom from domination by the military, foreign powers, totalitarian parties, religious hierarchies and economic oligarchies; and the political rights of minority groups. Source: Freedom House.

(3) *Voice and Accountability*: An index of surveys that rates countries on: ability of institutions to protect civil liberties, the extent to which citizens of a country are able to participate in the selection of governments, and the independence of the media. Source: World Bank Institute.

(4) *Government Effectiveness*: An index of surveys that rates countries on: The quality of public service provision, civil services' competency and independence from political pressures, and the government's ability to plan and implement sound policies. Source: World Bank Institute.

(5) *Rule of Law*: An index of surveys that rates countries on: the extent to which the public has confidence in and abides by rules of society; incidence of violent and non-violent crime; effectiveness and predictability of the judiciary; and the enforceability of contracts. Source: World Bank Institute.

(6) *Control of Corruption*: An index of surveys that rates countries on: The frequency of "additional payments to get things done," the effects of corruption on the business environment, "grand corruption" in the political arena and the tendency of elites to engage in "state capture." Source: World Bank Institute.

Encouraging Economic Freedom

(1) *Cost of Starting a Business*: The Private Sector Advisory Service of the World Bank Group works with local lawyers and other professionals to examine specific regulations that impact business investment. One of their studies measures the cost of starting a new business as a percentage of per capita income. Source: World Bank Group.

(2) *Inflation*: The most recent 12 month change in consumer prices as reported in the IMF's International Financial Statistics or in another public forum by the relevant national monetary authorities. Source: Multiple.

(3) *Fiscal Policy*: The overall budget deficit divided by GDP, averaged over a three-year period. The data for this measure is being provided directly by

the recipient government and will be cross checked with other sources and made publicly available to try to ensure consistency across countries. Source: National Governments and IMF WEO.

(4) *Days to Start a Business*: The Private Sector Advisory Service of the World Bank Group works with local lawyers and other professionals to examine specific regulations that impact business investment. One of their studies measures how many days it takes to open a new business. Source: World Bank Group.

(5) *Trade Policy*: A measure of a country's openness to international trade based on average tariff rates and non-tariff barriers to trade. Source: The Heritage Foundation's Index of Economic Freedom.

(6) *Regulatory Quality Rating*: An index of surveys that rates countries on: the burden of regulations on business, price controls, the government's role in the economy, foreign investment regulation and many other areas. Source: World Bank Institute.

Investing in People

(1) *Public Expenditure on Health*: Total expenditures by government at all levels on health divided by GDP. Source: National Governments.

(2) *Immunization*: The average of DPT3 and measles immunization rates for the most recent year available. Source: The World Health Organization WHO.

(3) *Total Public Expenditure on Primary Education*: Total expenditures by government at all levels of primary education divided by GDP. Source: National Governments.

(4) *Girls' Primary Completion Rate*: The number of female students completing primary education divided by the population in the relevant age cohort. Source: World Bank and UNESCO.

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